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To Disclose Or Not To Disclose: That Is The Question!

The IRS has burdened small captive participants and captive managers with disclosure requirements to produce information from closed years and, surprise, the IRS's own pronouncements disagree.

Controversy exists in the tax world regarding the extent of the disclosure obligations of participants in Section 831(b) captive transactions imposed by Notice 2016-66 and Notice 2017-08. This disclosure is due May 1, 2017. Specifically, tax practitioners and some Internal Revenue Service personnel disagree about whether Notices 2016-66 and 2017-08 require the disclosure of participation in closed tax years. As explained below, the IRS's own prior legal opinion agrees with the practitioner, not the IRS.

Notice 2016-66 labels certain captive insurance as transactions of interest and, as a result, named persons (including the business owner, the insured, the captive, and, if applicable, the reinsurance company) have disclosure obligations as participants "for each year in which their respective tax returns reflect tax consequences or a tax strategy." Treas. Reg. § 1.6011-4(c)(3)(i)(E); Notice 2016-66, § 3.02. Notice 2016-66 further provides that "[p]ersons entering into these transactions on or after November 2, 2006, must disclose the transaction as described in § 1.6011-4." Id at § 3.01.

Treas. Reg. § 1.6011-4 governs the form and content of the taxpayer's disclosure. A taxpayer required to disclose their participation in a transaction of interest must file a Form 8886, Reportable Transaction Disclosure Statement. Treas. Reg. § 1.6011-4(d). The Form 8886 must be attached to the appropriate tax return. Id. Treas. Reg. § 1.6011-4(e) governs when a taxpayer must file a Form 8886. A Form 8886 must be attached to the taxpayer's original and amended tax return for each tax year for which a taxpayer participates in a reportable transaction. Treas. Reg. § 1.6011-4(e)(1). At the same time, Form 8886 must be sent to the Office of Tax Shelter Analysis the taxpayer first files their Form 8886 with an original or amended return disclosing a particular reportable transaction. Id.

The regulations provide a separate rule for where the Service designates a transaction a listed transaction or transaction of interest after a taxpayer has filed their return. Treas. Reg. § 1.6011-4(e)(2)(i). Those rules provide:

In general, if a transaction becomes a listed transaction or a transaction of interest after the filing of a taxpayer's tax return (including an amended return) reflecting the taxpayer's participation in the listed transaction or transaction of interest and before

the end of the period of limitations for assessment of tax for any taxable year in which the taxpayer participated in the listed transaction or transaction of interest, then a disclosure statement must be filed, regardless of whether the taxpayer participated in the transaction in the year the transaction became a listed transaction or a transaction of interest, with OTSA within 90 calendar days after the date on which the transaction became a listed transaction or a transaction of interest. (emphasis added)

The consensus among practitioners remains that taxpayers must file Form 8886 for those tax years open on November 1, 2016. Practitioners point to Treas. Reg. § 1.6011-4(e)(2)(i)'s "period of limitations on assessment" language in support of the view. Practitioner's find additional support in the express language of Notice 2016-66. The Notice confirms that taxpayers constitute "participants in a transaction for each year in which their respective returns reflect tax consequences or tax strategy" of the captive insurance transaction of interest. Notice 2016-66, § 3.02.

Several commentators have reported conversations with IRS personnel, including the author of Notice 2016-66 and Notice 2017-08, suggesting that the IRS does not share their interpretation. The commentators note the Service seeks disclosure of all participation back to November 2, 2006 if a single tax year which reflects the tax consequences of operating a Section 831(b) captive remains open under the assessment period of limitations. The Service finds support in Section 3.01 of Notice 2016-66 and the title assigned to Treas. Reg. 1.6011-4(e), "Time for Providing Disclosure." Under this approach, an open limitations period sets forth the requirement to file Form 8886, but does not set forth how much to disclose. The IRS may contend that Treas. Reg. § 1.6011-4(e)(2)(i) also allows the Commissioner the authority to extend the period for disclosure. The language of Section 3.01 which requires disclosure by "persons entering into these transactions after November 2, 2006" sets forth the extent of such disclosure. Notice 2016-66, § 3.01. Effectively, select IRS personnel argue that that any disclosure obligation arising pursuant to Treas. Reg. § 1.6011-4(e)(2)(i) requires disclosure back to the November 2, 2006 date set forth in Notice 2016-66.

To put it nicely, the Service's current interpretation remains inconsistent with prior interpretations of Treas. Reg. § 1.6011-4(e)(2)(i). In Program Manager Technical Assistance 2015-11 ("PMTA 2015-11"), a copy of which is attached, the Office of Chief Counsel's Procedure & Administration division analyzed the impact of Treas. Reg. § 1.6011-4(e)(2)(i) on taxpayers' disclosure obligations with respect to a listed transaction described in Notice 2007-83. The facts note that the period of limitations for one tax year was closed as of the date of Notice 2007-83. The IRS confirmed the disclosure requirements of Treas. Reg. § 1.6011-4(e)(2)(i) and concluded:

For years with assessment periods that ended before the Service issued the listing notice, § 1.6011-4(e) does not impose any disclosure obligation.

While PMTA 2015-11 shares the interpretation espoused by many practitioners, PMTA 2015-11 is not binding upon the Service. Thus, the extent of the disclosure obligation imposed by Notice 2016-66 and Notice 2017-08 pursuant to Treas. Reg. § 1.6011-

4(e)(2)(i) remains in dispute. Moreover, Treas. Reg. § 1.6011-4(d), which governs the form and content of the disclosure, specifically notes that "an incomplete Form 8886 ... containing a statement that information will be provided upon request is not considered a complete disclosure statement." Section 6707A imposes stiff penalties on participants who fail to properly disclose their participation.

Since taxpayers may incur substantial penalties for any failure to appropriately disclose their participation in a Section 831(b) captive transaction, it would seem prudent to disclose information back to the earlier of the first year of the transaction or 2006. Of course, all affected taxpayers should take the most protective position possible and contact their tax professionals to discuss how to satisfy their disclosure obligations in light of this uncertainty.

Office of Chief Counsel Internal Revenue Service

memorandum

CC:PA:02:DSkinner POSTN-101991-15

UILC: 6662A.OO-OO

date: April 13, 2015

to: Ronk, Alice L.
Attorney-advisor
(SB/SE Headquarters, Exam Operations)

from: Ashton P. Trice
Chief, Branch 2
(Procedure & Administration)

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subject: Reportable transaction understatement penalty questions; section 6662A

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

BACKGROUND

From 2003 through 2011, taxpayers participated in, but did not disclose, a listed transaction described in Notice 2007-83, 2007-2 C.B. 960, which describes abusive arrangements using cash-value life insurance policies purportedly to provide welfare benefits. On October 17, 2007, when the Service issued Notice 2007-83, tax years 2004 and later were open for assessment. The Service is making a single adjustment for the accumulated value of the insurance policies, in a year for which the assessment period remains open (the adjustment year).

As we understand it, one or more provisions applicable to the taxation of the benefits provided through the arrangement requires the taxpayer to include in income each year the fair market value of the insurance policy(ies) on the life of the taxpayer, but reduced by amounts previously included in income. Thus, in cases where a taxpayer had not yet

included any amount in income prior to the adjustment year, the entire amount would be includible in the adjustment year. Generally this amount would be the Accumulation Value (the policy's cash value without regard to surrender charges) of the policy. Questions on adjustments made under these rules should be directed to CC:TEGE. This memorandum considers only the specific penalty issues presented below.

ISSUES

1. If part of the accumulated value derives from a year before the Service issued Notice 2007-83, but the Service is making the accumulated value adjustment in an open year after the listing notice and for which the taxpayer failed to disclose the transaction, is the entire section 6662A reportable transaction understatement penalty imposed at the thirty-percent rate?
2. When computing the section 6662A penalty, must the Service apportion the penalty between the closed year the transaction was not listed and the open years when it was listed and for which the taxpayers failed to disclose?
3. When proposing for the adjustment year an accumulated-value adjustment resulting from several years of participation in the listed transaction, which "highest rate of tax" applies for computing the section 6662A penalty?
4. Should the Service somehow apportion the accumulated-value to a number of years and compute the penalty using the highest applicable tax rate for each year to that year's portion?

CONCLUSIONS

1. Yes, the entire section 6662A penalty is properly imposed at the higher thirty percent rate provided in section 6662A(c), because there is a reportable transaction understatement and the taxpayers failed to satisfy the requirements of section 6664(d)(3)(A) by disclosing their participation in the transaction as required under section 6011 and § 1.6011-4(e)(1) and (e)(2)(i).
2. No. The reportable transaction understatement also occurs in the adjustment year, and apportionment is neither necessary nor appropriate.
3. The "highest rate of tax" is whatever the highest rate of tax is under section [1] for individual taxpayers, for the year of the adjustment.
4. No. The highest rate of tax used to compute the section 6662A penalty is the highest rate for the adjustment year, and no apportionment is appropriate.

LAW AND ANALYSIS

The section 6662A penalty applies when a taxpayer has a reportable transaction understatement. Sec. 6662A(a).

Section 6662A(c) imports the disclosure requirement from section 6664(d)(3)(A) and imposes a 30-percent penalty, rather than the standard 20-percent penalty, on the portion of any reportable transaction understatement with respect to which the disclosure requirement is not satisfied. 1 Persons liable for tax must make returns or statements as

required by regulations. Sec. 6011(a). Taxpayers who participate in reportable transactions and who are required to file tax returns must file a disclosure statement within the time prescribed in § 1.6011-4(e). Treas. Reg. § 1.6011-4(a).

Taxpayers must submit the disclosure statement with their tax return and with each amended return reflecting their participation. Treas. Reg. § 1.6011-4{e)(1). When a transaction becomes a listed transaction after a return is filed and before the end of the period of limitations on assessment for any year the taxpayer participated in the listed transaction, the taxpayer must file a disclosure statement within 90 days after the date the transaction became a listed transaction.[2] Treas. Reg. § 1.6011-4(e)(2)(i). For years with assessment periods that ended before the Service issued the listing notice, § 1.6011-4(e) does not impose any disclosure obligation.

On the facts you presented, the taxpayers participated in the listed transaction during each year from 2003 through 2011, the Service is making the accumulated-value adjustment in a year with an open assessment period, and the taxpayers did not disclose their participation on the return for that year. The reportable transaction understatement resulting from that transaction, therefore, is subject to the 30-percent penalty for nondisclosed listed transactions. Sec. 6662A(c). The fact that some of the accumulated value could have been reported in a closed year is not relevant. Of course, if the taxpayers had included any of the cash value in income in any year before the adjustment year, that amount would not be part of the accumulated-value adjustment in the adjustment year.

Because the Service is making the adjustment in the adjustment year, the "increase (if any) in taxable income which results from a difference between the proper tax treatment of an item to which this section applies and the taxpayer's treatment of such item (as shown on the taxpayer's return of tax)", sec. 6662A(b)(1)(A), occurs in that year.

To determine the reportable transaction understatement, the increase in taxable income resulting from the difference between the proper tax treatment and the taxpayer's treatment is multiplied by the highest rate of tax imposed by section 1 for individuals. Sec. 6662A(b)(1)(A). The highest rate under section 1 is currently 39.6 percent. See sec. 1(a), (b), (c), (d), (e), and (i)(3). The penalty is 30 percent of the reportable transaction understatement. Sec. 6662A(C).

The penalty should not be apportioned over several years, nor should the highest rate be some blend of the highest rate from several years. Rather, the penalty is calculated from the adjustment made in the adjustment year, using the highest rate for that year.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call David Skinner at (202) 317-6844 if you have any further questions.

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1 The reference in sec. 6662A(c) to sec. 6664(d)(2)(A) does not reflect the insertion of new sec. 6664(d)(2) in 2010. Sec. 6662A(c) should be interpreted as referring to current sec. 6664(d)(3)(A).
2 Listed transactions are a subset of reportable transaction. Treas. Reg. § 1.6011-4(b)(1), (2).

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